UNITED
NATIONS

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United Nations
Conference
on Trade and
Development

Distr
GENERAL

TD/B/COM.2/CLP/23
18 June 2001

Original: ENGLISH

TRADE AND DEVELOPMENT BOARD
Commission on Investment, Technology and Related Financial Issues
Intergovernmental Group of Experts on Competition Law and Policy
Third session
Geneva, 2-4 July 2001
Item 3 of the provisional agenda

MODEL LAW: THE RELATIONSHIPS BETWEEN A COMPETITION AUTHORITY AND REGULATORY BODIES, INCLUDING SECTORAL REGULATORS

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INTRODUCTION

1. It will be recalled that paragraph 11 of resolution TD/RBP/CONF.5/15, adopted by the Fourth United Nations Conference to Review all Aspects of the Set of Multilaterally Agreed Principles and Rules for the Control of Restrictive Business Practices, requested UNCTAD to prepare a new chapter of the model law on the relationship between a competition authority and regulatory bodies, including sectoral regulators. The present document contains proposals for a new article, together with commentaries suggesting how to promote competition in the public utilities and infrastructure industries. Also, it suggests how to promote efficiencies through the development of appropriate competition law and institutions, how to protect general interest within industries opened to competition, and how to organize the relationship between competition agencies and regulatory agencies.

2. The proposals are presented taking into account a number of peculiarities of less mature market structure, and focus primarily on how to increase the efficiencies of regulated industries of developing countries and countries in transition.

POSSIBLE ELEMENTS FOR A NEW ARTICLE ON COMPETITION AND REGULATION

Advocacy role of competition authorities with regard to regulation and regulatory reform

3. An economic and administrative regulation issued by executive authorities, local self-government bodies or bodies enjoying a governmental delegation, especially when such a regulation relates to sectors operated by infrastructure industries, should be subjected to a transparent review process by competition authorities prior to its adoption if it limits the independence and liberty of action of economic agents and/or if it creates discriminatory or, on the contrary, favourable conditions for the activity of particular firms -- public or private -- and/or if it results or may result in a restriction of competition and/or infringement of the interests of firms or citizens.

4. In particular, regulatory barriers to competition incorporated in the economic and administrative regulation, should be assessed by competition authorities from an economic perspective, including for general-interest reasons.

Definition of regulation

5. The term " regulation " refers to the various instruments by which Governments impose requirements on enterprises and citizens. It thus embraces laws, formal and informal orders, administrative guidance and subordinate rules issued by all levels of government, as well as rules issued by non-governmental or professional self-regulatory bodies to which Governments have delegated regulatory powers.

Definition of regulatory barriers to competition

6. As differentiated from structural and strategic barriers to entry, regulatory barriers to entry result from acts issued or acts performed by governmental executive authorities, by local self-government bodies, and by non-governmental or self-regulatory bodies to which Governments have delegated regulatory powers. They include administrative barriers to entry into a market, exclusive rights, certificates, licences and other permits for starting business operations.

Protection of general interest

7. Irrespective of their nature and of their relation to the market, some service activities performed by private or government-owned firms can be considered by Governments to be of general interest. Accordingly, the providers of services of general interest can be subject to specific obligations, such as guaranteeing universal access to various types of quality services at affordable prices. These obligations, which belong to the area of social and economic regulation, should be set out in a transparent manner.

COMMENTARIES TO THE PROPOSED ARTICLE ON COMPETITION AND REGULATION

8. The broad and commonly admitted purpose of competition policy is to minimize the economic inefficiencies created in markets by anti-competitive behaviours.[1] Competition policy consists not only of competition law enforcement, but also of trade liberalization and deregulation in the interest of consumers' welfare. Competition law and policy are intended to regulate non-competitive behaviours by firms, whereas deregulation is aimed at minimizing market-distorting government intervention.

Advocacy role of competition authorities with regard to regulation and regulatory reform

9. Elements related to the proposed article raise two issues, which need to be treated separately.

1. Why do Governments pay particular attention to the performance of certain economic activities?

10. Governments tend to develop extensive and comprehensive sectoral rules applying in particular to major infrastructure service industries. Such industries, also referred to as "public utilities" or "public services", include activities where consumption is indispensable for the development of modern ways of life or which provide essential inputs to many parts of a nation's economy, such as electricity, gas, water production and distribution, solid waste management, telecommunications, cable television, mail distribution and public transportation (by air, road or rail).[2]

11. There are four main reasons why Governments attach great importance to infrastructure service industries both in developed and developing countries and in countries in transition. Governmental prescription of their functioning distinguishes them in four ways from common and traditionally competitive sectors of the economy: by control of entry, price fixing or capping, and the quality and the conditions of service prescriptions.

12. The first reason is that these industries are fundamental to the performance of the economy as providers of inputs for all other sectors of activity. The conditions of their operations and efficiency may determine not only the general productivity and level of competitiveness of a country but also social order and even political stability if consumers express general dissatisfaction. It follows from the essential nature of these industries that they often have public or universal service obligations, which means that the firms -- public or private -- are required to provide a particular service even when it is not economic for them to do so. Thus, infrastructure service industries may not be competitive where there are regulatory restraints on competition in the activity concerned. Restraints are imposed on competition for various reasons, including, most commonly, to permit a firm to find a source of revenue to fund mandated non-commercial activities and services. For example, a national postal operator often has protection from competition in standard letter mail, which is justified on the ground that it is necessary in order to protect the cross-subsidization of letter delivery in high-cost areas such as rural areas. The result is that reform of these sectors which are essential to a country's activity and are protected from competition for social and political reasons is often highly politicized.

13. The second reason is that the activities of these infrastructure service industries can be performed only by a very small number of operators at the national level; in other words, most governmental entities, such as local government units (e.g. cities, provinces, federated States), are faced with a very strong and concentrated bargaining power. In many countries central or local governments have decided to assume direct ownership of infrastructure service industries.

14. The third reason, which has a bearing on regulation and competition, is that these industries often involve considerable barriers to entry or exit, such as sunk costs which are unrecoverable once they have been committed. In particular, the sequence of operations is of importance with respect to governmental regulation: often, major investments have first to be made in a situation where investors commit to the market and second rents or revenues will arrive over a period of several years. This means that, to attract voluntary private investment, the framers of the regulatory regime have to make it credible and predictable. This concern for credibility is often shared by Treasury policy-makers. Creating credibility and predictability is one of the basic tasks of a regulator.

15. The fourth, and final, reason why Governments attach great importance to infrastructure service industries derives from supply, costs and demand effects, owing to the fact that such a sector is not made up of a single homogeneous activity but comprehends a number of separate components. Some parts of these components cannot sustain competition, generally because of the presence of economies of scale, a situation in which a single firm in a defined area can meet market demand more efficiently than any combination of two or more firms. This component which cannot sustain competition usually requires the use of a privilege, or exclusive right of use of some public good which is owned by the Government and has to be given or lent by it. An infrastructure service industry may also not be able to sustain competition owing to the presence of " network effects " or "demand-side economies of scale" -- that is, when the demand for a firm's services increases with the consumption of those services.[3]

16. From the particular perspective of developing countries, it should be stressed that market structure often raises serious concerns about enhancing efficiency through regulatory reform and opening regulated industries to competition.

17. For instance, it has been recently and repeatedly observed that the process of reform utilities in South America has not considered market evaluation prior to privatization of public assets in infrastructure industries. The regulated and unregulated activities constituting the market structure were generally undifferentiated, owing to earlier government intervention.[4] Asian developing countries are having a similar experience as regulatory review processes are initiated. For instance, a representative of Papua New Guinea recently stressed the fact that regulatory restrictions imposed by government regulation or government ownership are an impediment to competition. In Papua New Guinea, the existing regulations were put in place when there was greater confidence in them, but less appreciation of their costs:

> "Examples include legislated monopolies for public utilities, statutory marketing arrangements for many agricultural products and licensing arrangements for various occupations and professions. The Central Agencies Working Group will carry out a review of barriers to entry... Structural reforms may be required to dismantle excessive

market power that may impede the introduction of effective competition. In order for privatization to achieve its objective of improved efficiency, it is important for these structural reforms to be carried out first. This will require structural separation in two areas: the separation of regulatory and commercial functions and the separation of natural monopolies and potentially competitive activities. [5]

18. The examples given by the official from Papua New Guinea show that developing countries' concerns are indeed very close to those of developed countries. Efficient regulation in developed countries traditionally distinguishes between network segments which are non-potentially competitive and segments of production and retailing which are generally considered to be natural monopolies and non-potentially competitive. Potentially competitive segments comprise, for instance, long distance in telecommunications, generation in electricity and transportation in railways. Non-potentially competitive segments include the transmission grid in electricity, the tracks in railways and the local loop in telecom communications; they often remain regulated after competition of the regulatory reform process. It is clear that the lack of effective separation gives market power to firms operating network infrastructures. Such power, exercised at the expense of other operators and consumers, should be kept under control.

2. What should be the role of competition agencies with respect to regulation?

19. From a market structure point of view, the competition authorities should be consulted when a process of regulatory reform is being undertaken as a part of a privatization programme. They should be given legal powers to impose divestiture measures on existing monopolies or to control or prohibit mergers that undermine competitive market structures. If they are not given such powers, for instance because of lack of human resources, it should be made possible for them to suggest divestiture measures or merger controls to an executive authority that has those powers.[6] Nevertheless, it is clear that the dominant pattern of distribution of roles between competition agencies and regulatory agencies is rarely one whereby competition authorities simply replace regulatory agencies.

20. However, it is interesting to look at the present relationship between competition authorities and sectoral regulators in most member countries of the Organisation for Economic Co-operation and Development (OECD). At recent roundtable on the relationships between competition authorities and regulatory authorities, organized by the OECD Committee on Competition Law and Policy, attempts were made to define the main policy questions raised by the relationships between regulators and competition authorities.[7] A study of these relationships shows that the competitive process can be appropriately stimulated by the intervention of competition authorities when firms in a regulated sector abuse their privileges to the detriment of consumer interests and the efficiency of firms that use their regulated services. The experience of deregulation in the most developed countries gives rise to four main observations:

21. First, there are specific regulatory regimes in many sectors in OECD countries; they are particularly common in sectors such as telecommunications, electricity, railways and natural gas. However, such regimes are also found in radio and television broadcasting, civil aviation, cable television, ocean shipping, pharmaceuticals, radioactive minerals, alcoholic beverages, insurance, banking, inter-city bus transportation and trucking, and water distribution, as well as in numerous other sectors.

22. Second, there is no unique model for the relationship between sector-specific regulators and competition authorities either across countries or sometimes even within a country. However, one particular model -- the mandate-driven division of labour approach -- appears to be somewhat more common than others. It is clear, at least, that sectoral regulators should be separated from regulated firms or entities and should assume obligations regarding accountability and independence from the executive branch of government. Also, institutional changes should be effected in order to guarantee their independence. As recently and repeatedly pointed out by officials from the Republic of Korea, since sector-specific enforcement of competition law may characterized by inconsistencies, regulators should first consult and coordinate with competition authorities.[8]

23. Third, in countries that deregulated somewhat earlier than others, a rather pragmatic approach seems to have emerged, which differs empirically from one sector to another. Countries liberalizing somewhat later appear to have followed a more systematic approach.

24. Finally, there is a good deal of variation across countries in the terminology used. Some countries make a distinction between technical regulation, economic regulation and competition law enforcement. But sometimes, "competition policy" seems to be included in "economic regulation". In some OECD countries, there also appears to be a tendency to use "economic regulation" and "technical regulation" interchangeably.

Definition of Regulation

25. Regulation can pursue different types of objectives. Economic regulation, social regulation and administrative regulation are among the three main categories of government intervention which may have a bearing on the market. Economic regulation includes government requirements which intervene directly in market decisions, such as pricing, competition, and market entry or exit. Social regulation includes government requirements which protect public interests such as health, safety, the environment and social cohesion. Administrative regulation includes paperwork and formalities through which Governments collect information and intervene in individual economic decisions.

Competition law and policy and regulation

Basically, competition law and policy and regulation aim at defending the public interest against monopoly power. Although both provide a Government with tolls to fulfil this objective, they vary in scope and types of intervention. Competition law and policy and regulation are not identical. There are four ways in which competition law and policy and regulatory problems can interact:

- *Regulation can contradict competition law and policy*. Regulations may have encouraged, or even required, conduct or conditions that would otherwise be in violation of competition law; for example, regulations may have permitted price coordination, prevented advertising or required territorial market division. Other examples include laws banning sales below cost, which purport to promote competition but are often interpreted in anti-competitive ways, and the very broad category of regulations that restrict competition more than is necessary to achieve regulatory goals. Modification or elimination of these regulations compels the firms affected to change their habits and expectations.

- *Regulation can replace competition law and policy*. In natural monopolies, regulation may try to control market power directly by setting prices (price caps) and controlling entry and access. Changes in technology and other institutions may lead to reconsideration of the basic premise in support of regulation, namely that competition policy and institutions would be inadequate to the task of preventing monopoly and the exercise of market power.

- *Regulation can reproduce competition law and policy*. Coordination and abuse in an industry may be prevented by regulation and regulators, as is done by competition law and policy. For example, regulations may set standards of fair competition or tendering rules to ensure competitive bidding. However, different regulators may apply different standards, and changes or differences in regulatory institutions may reveal that seemingly similar policies have led to different practical outcomes.

- *Regulation can use competition policy methods*. Instruments to achieve regulatory objectives can be designed to take advantage of market incentives and competitive dynamics. Coordination may be necessary in order to ensure that these instruments work as intended in the context of competition law requirements.

Sources : OECD and EU Commission.

Definition of regulatory barriers to competition

26. Regulatory barriers to competition consist of measures taken by state administrations (e.g. central or federal government, local government) or by bodies enjoying a governmental delegation, which prevent or hamper effective competition and which in the final analysis lead to a loss in welfare. Such measures are to be found in as diverse activities as telecommunications, financial services (banking and insurance), professional business services (accounting, lawyers, architects etc.), and the energy sector (electricity, gas), as evidenced by an abundant literature.[9] These measures, which can negatively affect market entry, market exit and market operation, take a wide variety of forms, such as:

- Restraints on competition, i.e. by introducing uncommon norms and standards amounting to barriers to market entry or by preventing foreign firms from competing in national market;
- Elimination or exclusion from competition through exemption of certain activities from the scope and coverage of competition laws[10];
- Creation of distortions to competition, such as artificial executive interventions changing the competitive positions of certain firms (through arbitrary public procurement policy decisions, for instance).

27. Regulatory barriers to competition not only relate to market entry but also can prevent market exit from happening, for instance through public subsidization or the granting or prolongation of monopoly rights. In addition, they can make it harder for resources to be allocated from one sector or market segment to another. They can be considered barriers to mobility which prevent resources from being transferred into more efficient sectors or segments, and which in the end will reduce allocative efficiency.

Efficient regulation principles for the removal of regulatory barriers to competition

Efficient regulation principles should be built into domestic regulatory processes for social and economic regulations as well as administrative formalities. They are particularly useful with regard to regional economic integration. Such principles include:

- *Non-discrimination, especially in respect of standards.* There should be equality of competitive opportunities between like products and services, irrespective of countries of origin. Performance-based rather than design standards should be used as the basis of technical regulation; taxes or tradable permits should be used in place of regulation. When appropriate and feasible, internationally harmonized measures should be used as the basis of domestic regulations.

- *Recognition of equivalence of other countries' regulatory measures.* When internationally harmonized measures are not possible, necessary or desirable, the negative effects on cross-country markets caused by disparities in regulation and duplicative conformity assessment systems can be reduced by recognizing the equivalence of trading partners' regulatory measures or the results of conformity assessment carried out in other countries.

Source : OECD, *Report on Regulatory Reform*, Paris, 1997.

Protection of general interest

28. The protection of general interest is generally the most frequent feature sustaining regulation. Where it has been recognized that free competition cannot or does not provide sufficient results with regard to the quality, regularity, affordability, territorial coverage and security of services of general interest, generally performed by infrastructure service industries, Governments should be allowed to impose non-discriminatory and transparent regulations on all operators in the market, compelling them to meet certain standards for as long as they are operating in the market. Such a competition-friendly way of ensuring services of general economic interest has been the subject of in-depth research and study in the European Union, in connection with legislation designed to liberalize various sectors of the economy.[11]

NOTES

[1] N. MUHAMMAD, *Promoting Competition in Regulated Sectors or State Enterprises and the Role of Government on Monopoly Practices in Indonesia*. Fifth APEC/PFP Course on Competition Policy, Bangkok, March 2001.

[2] A recent OECD roundtable, organized by the Committee on Competition Law and Policy, has shown that specific regulatory regimes can also be found in radio and television broadcasting, cable television, civil aviation, ocean shipping, pharmaceuticals, banking, inter-city bus transportation and trucking, etc. See OECD, "The relationship between competition and regulatory authorities", *OECD Journal of Competition Law and Policy*, Paris, 1999, vol. 1, no.3, p. 169- 246. See also the papers produced for a recent Inter-American Development Bank symposium, held in Washington, DC, in April 2001, on competition policy issues in infrastructure industries.

[3] These network effects or "network externalities", often arise in information and communication technology industries. There are often benefits derived from being on a larger network, or on a more widely adopted standard, as it increases the number of people with whom one can interact or conduct economic transactions. Provided there are costs of being connected to (or compatible with) two or more networks (or standards), consumers will pay more for being on a larger network. Markets which exhibit sizeable network externalities may only be able to sustain a single firm. These facts emerge from studies by the OECD Committee on Competition Law and Policy in connection with the elaboration of an OECD recommendation on the separation of vertically integrated industries, which was drafted in 2000. See in particular OECD, *Structural Separation in Regulated Industries*, Paris, 2000.

[4] See I. De Leon, *The Role of Competition Policy in the Regulation of Infrastructure Industries: Some Lessons from the Latin American Experience*. Washington, DC, *Inter-American Development Bank* Working Paper, 2001.

[5] R.G. Maru, Promoting Competition in Regulated Sectors or State Enterprises in Papua New Guinea. Fifth APEC/PFP Course on Competition Policy, Bangkok, 2001.

[6] It has recently been stressed that in the case of developing countries in South America, competition institutions very often do not have the power to impose penalties or to overrule the regulatory authorities' decision. "When immunity from competition law enforcement is provided for regulated firms, there is no assurance that they will be properly regulated in this respect, should a case arise, as regulatory agencies lack the expertise in handling competition regulation. In these cases, when conduct is detected, and no competition authority intervenes (as a result of the immunity from competition law enforcement), there are no legal powers granted to the regulatory agency to intervene." This is the case, for example, of Colombia's as well as Argentina's Regulatory Commission for Energy, "which detected abusive behavior among gas producers, but could not intervene". De Leon, op. cit., p.3.

[7] *Roundtable of the Committee on Competition Law and Policy on Competition Authorities and Regulation*, Paris, OECD, 1999 (see footnote 2).

[8] Among many statements, see Chul Ho Ji, *Promotion of Competition in State-owned Enterprises (SOEs) and Regulated Sectors in Korea*. Fifth APEC/PFP Course on Competition Policy, Bangkok, 2001.

[9] See in particular OECD, *Report on Regulatory Reform*, vols. I and II, Paris, 1997. With regard to developing countries and countries in transition, see D. Zemanovicova, *Regulatory Barriers to Economic Competition in Transitional Countries*, Bratislava, 1998 (published under the Phare-ACE programme).

[10] See, for instance, OECD, *Antitrust and Market Access: The Scope and Coverage of Competition Laws and Implications for Trade*, Paris, 1996.

[11] The EU policy of liberalization is rooted in number or texts called "directives". The main legal texts incorporating the notion of services of general interest as well as provisions on competition preserving the general interest are the following: Council Directive concerning the co-ordination of procedures for the award of public works contracts 71/305/EEC, OJEC 1971, L185/5, as amended by Directive 89/440/EEC, OJCE 1989, L210/1 and codified by Directive 93/37 OJEC 1993, L 199; Council Directive 77/62/EEC concerning the co-ordination of procedures for the award of public supply contracts, OJEC 1977/ L 13/1, codified by Directive 93/96 EEC, OJEC 1993 L 199; Council Directive 89/665/EEC on the co-ordination of the laws, regulations and administrative provisions relating to the application of review procedures for the award of public supply and public work contracts, OJEC 1989, L 395/33, modified by Directive 92/50 OJEC 1992, L 209; Council Directive 90/531/EEC on the procurement procedures of entities operating in water, energy, transports and telecommunications sectors, OJEC 1990, L297/1, codified by Directive 93/38, OJEC 1993 L 199; Council Directive 92/13/EEC co-ordinating the laws, regulations and administrative provisions relating to the application of Community rules on the procurement procedures of entities operating in water, energy, transports and telecommunications sectors, OJEC 1992 L 76/14; Council Directive 92/50/EEC relating to the co-ordination of procedures for the award of public services contracts, OJEC 1992, L 209/1. Furthermore, to define what is meant by "general interest", the European Commission explained in its Guidelines in 1996 that the extension of competition rules would not run counter to obligations of public service that might be imposed by the public authorities on the entities -- public or private -- that perform services for protection of economic, and social cohesion, the environment, the planning and promotion of consumers interests, and land use. See EU Commission, *Communication on Services of General Interest in Europe*, Brussels, September 1996.